No. 16024

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ADVANCE TRUCK COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR THE PETITIONER.

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TABLE OF AUTHORITIES CITED

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A canon of statutory interpretation is that the parts of a statute are to be construed together to produce a harmonious and consistent result. The opinion below and the Respondent in his brief construe Section 42, 1939 Internal Revenue Code to be independent of and unrelated to Section 41, Internal Revenue Code. It is submitted that there is no conflict between the two provisions.

Under Section 41, the net income is to be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, but if the method of keeping the books does not clearly reflect the income, the computation is to be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. The Respondent concedes (Br.

11) that the accrual method of accounting clearly reflects the Petitioner's income for the year 1950. The Respondent further concedes (Br. 7), that on the accrual method of accounting the amounts collected during January, 1950, for services rendered in 1949, would have represented accounts receivable at December 31, 1949. Therefore, the two requirements of Section 42 are here met. The accrual method is a method of accounting permitted under Section 41 and under this method of accounting the items of gross income, *i.e.*, accounts receivable, are properly accounted for *as of* a different period than the taxable year in which received by the taxpayer.

Section 42 means only that items of gross income are to be accounted for according to the method of accounting employed by the taxpayer in the taxable year of reporting. This is borne out by the Respondent's own regulation [Reg. 111, Sec. 29.42-1] which provides that the method of accounting determines the year of inclusion of items of gross income (Pet. Br. App. A. 4). Thus interpreted there is no conflict between Sections 41 and 42.

As pointed out by the Tax Court in *V. T. H. Bien* (1953), 20 T. C. 49, there is almost perfect circuity of reasoning between Sections 41, 42 and 43, 1939 Internal Revenue Code, but the key language as exemplified by Sections 41 and 43 is "clearly reflect the income." There can be no quarrel with the Respondent's statement (Br. 17) that income tax liability is to be computed upon an annual basis. That is required by the statute, the regulations and case law. The Respondent has conceded that the accrual method of accounting *clearly* reflects the Petitioner's income for the year 1950. How then can the inclusion of income for another period according to the accrual method clearly reflect the results of the Petitioner's operations for 1950? The receipts were not earned in 1950 according to the accrual method and their inclusion has the effect of putting 13 months earnings into the calendar year 1950.

None of the cases cited by the Respondent in his brief support his contention as to Section 42 (Br. 13). *Sivley v. Commissioner* (C. A. 9, 1935), 75 F. 2d 916, involved a question of the statute of limitations. *Ross v. Commissioner* (C. A. 1, 1948), 169 F. 2d 483, involved the question of constructive receipt. *Healy v. Commissioner,* 345 U. S. 278, 97 L. Ed. 1007, involved the question as to whether corporate salary payments found by the Commissioner to be excessive compensation should be excluded from income in the year of receipt or whether an adjustment should be made in a later year when the taxpayer was required to pay income tax deficiencies as a transferee of the corporation's assets.

Goodrich v. Commissioner (C. A. 8, 1957), 243 F. 2d 686, extensively relied upon by the Respondent here does not support his position, but on the contrary is squarely in favor of the Petitioner.

In *Goodrich,* the taxpayer prior to 1949 used a hybrid method of keeping his books and making his returns. Sales were recorded and reported on a cash basis while an accrual basis was used as to other elements. On January 1, 1949, the taxpayer changed his method of accounting to a strict accrual basis and reported his income on this basis for the calendar year 1949. The Commissioner audited the taxpayer's return for the year 1949 and determined that the accounts receivable accumulated prior to 1949 should be includible in the taxpayer's income in the year of changeover. The Tax Court sustained the determination of the Commissioner on the grounds that a taxpayer may not change his method of accounting without first obtaining the consent of the Commissioner and that as a condition of granting his consent the Commissioner has the right to impose such terms and conditions as he deems appropriate to prevent income from otherwise escaping taxation. Therefore, a taxpayer who changed his method of accounting without first obtaining consent is subject to the same adjustment order as one who does. (*William H. Goodrich* (1956), 25 T. C. 1235.) The Court of Appeals reversed the decision below on the grounds that Section 41 and the regulations did not empower the Commissioner to impose upon a taxpayer such conditions as he saw fit but only such conditions as to which the Commissioner and the taxpayer agree. The Court of Appeals specifically held that the Commissioner could not add to the income for the year 1949 the accounts receivable of prior years, since under Section 41, 1939 Internal Revenue Code, the accounts receivable were not income of the taxpayer, Goodrich, in the year 1949 under the method of accounting followed by him in that year, *i.e.,* the accrual method. The Court cited as its authority *Security Flour Mills Co. v. Commissioner,* 321 U. S. 281, 64 S. Ct. 596, 88 L. Ed. 725. It should be noted that the Court did not cite Section 42, 1939 Internal Revenue Code in its opinion.

The Respondent asserts that the Court of Appeals in the *Goodrich* case held that the taxpayer there must report the accounts receivable as they are received and that the case was remanded to the Tax Court for a redetermination of the tax due taking into account the amounts of accounts receivable received in the year before the Court (Br. 15-16). This is pure flight of fancy on the part of the Respondent. There is no language in the opinion of the Court of Appeals which states that the case was remanded for a determination of the tax due taking into account collections on accounts receivable as they were collected. The finding of fact of the Court below would preclude such a result. The Tax Court in its opinion, 25 T. C. 1235, 1236, stated that the taxpayer, Goodrich, reported his income on a strict accrual basis for the years 1949 and 1950. The language of the Court of Appeals stated by the Respondent to be a holding does not even rank as dictum. It is apparent that the Court regarded the action of the taxpayer, Goodrich, in reporting collections of the accounts receivable in later years as a voluntary act not required by any provision of the Internal Revenue Code. Whether he did or did not is questionable in view of the findings of fact of the Tax Court. The Court specifically stated that even if the income escaped taxation altogether, the Commissioner could not tax the accounts receivable in the year of changeover.

The Respondent suggests (Br. 19, n. 5) that the case of *William Hardy, Inc. v. Commissioner* (C. A. 2, 1936), 82 F. 2d 249, is compatible in principle with *Goodrich v. Commissioner, supra.* It is submitted that the same Court of Appeals which disavowed the *Hardy* decision in its opinion in *Welp v. Commissioner* (C. A. 8, 1953), 201 F. 2d 128, did not intend to re-establish the *Hardy* rationale in its later opinion.

The opinion of the Eighth Circuit in *Goodrich* is also a complete answer to the Respondent's contention (Br. 14-15) that since this is the usual type of adjustment required by him where a taxpayer requests permission to change his method of accounting, he can impose such an adjustment unilaterally where the taxpayer changes his method of accounting without first obtaining his consent.

The Petitioner, more than a year before the issuance of the notice of deficiency, filed a claim for refund for the year 1950 on the basis that it should have reported its income on a cash basis [R. 10, 37]. The Respondent in his notice of deficiency rejected this claim for refund and stated that the Petitioner was required to report on the accrual basis [R. 11-12]. A claim for refund is a statutory remedy for the correction of an error by the taxpayer in the reporting of income. (*Crosley Corporation v. United States* (C. A. 6, 1956), 229 F. 2d 376.) The denial of Petitioner's claim was a determination by the Commissioner that Petitioner was required to report on the accrual basis. The situation is the same as if the Petitioner had reported its 1950 income on the cash basis and the Commissioner had later determined a deficiency on the grounds that the Petitioner should have reported on the accrual method. In the latter situation the Courts have uniformly denied the Commissioner the right to add to a taxpayer's income for the year of changeover the accounts receivable of prior years.

The Petitioner admits that if the accounts receivable at December 31, 1949, are not included in its income for the year 1950, they will escape taxation. This fact does not require the affirmance of the decision below. The result of all of the cases which have considered the question, whether it involved opening inventories or accounts receivable, has been to relieve the taxpayer of taxation on part of his income. This fact emphasizes that the 1939 Internal Revenue Code was deficient on the problem herein involved. It was for this reason that Congress enacted Section 481, 1954 Internal Revenue Code. At the same time Congress refused to make the new provision retroactive in its application to taxable years beginning before the effective date of the 1954 Internal Revenue Code (Sen. Rept. No. 1622, 83rd Cong. 2nd Sess., p. 65).

It should be noted that the Court of Appeals in *Goodrich, supra,* considered the problem there presented as one which prompted the enactment of Section 481, 1954 Internal Revenue Code.

Conclusion.

The appellate courts which have considered the question presented by this appeal have uniformly held that under Section 41, 1939 Internal Revenue Code, the taxpayer's method of accounting controls the time as of which income must be reported. It is agreed by the Respondent that the accrual method of accounting clearly reflects the Petitioner's income for the calendar year 1950, which is the year before this Court. Therefore, the strict accrual method must be followed. There is no authority for the hybrid method advocated by the Respondent. It follows that the decision of the Tax Court must be reversed.

Respectfully submitted,

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Attorneys for Petitioner,

October 13, 1958.